Petition

81-768

No. 81-.....

Office-Supreme Court, U.S.
FILED
OCT 13 1981
ALEXANDER L. STEVAS,
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

JOSEPH D. UNDERWOOD

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

JOEL HELD
BRUCE A. BUDNER
Durant, Mankoff, Davis,
Wolens & Francis
3900 First National Bank
Building
Dallas, Texas 75202
(214) 748-0074

Attorneys of Record for Petitioner

Bowne of Dallas, Inc. Printed in U.S.A.

INDEX

Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statute Involved	2
Statement of Case	3
Reasons for Granting the Writ	5
Conclusion	12

QUESTIONS PRESENTED

(1) Whether prior securities violations alone, in the face of the lengthy lapse of time between the alleged violations and the summary judgment, the change of circumstances imposed by the Securities and Exchange Commission (herein "SEC"), and the admission by the SEC that there exists no proof of continuing violations, satisfy the requirements of Section 21(d) of the Securities Exchange Act of 1934 (herein "Exchange Act") for issuance of an injunction.

(2) Whether the complaint in this case filed by the SEC pursuant to Section 21(d) of the Exchange Act (alleging violations of Section 10-b of the Exchange Act), must contain specific allegations of intentional wrongdoing — scienter — after *Aaron v. SEC.*

TABLE OF AUTHORITIES

Cases

Aaron v. SEC, 446 U.S. 680, 100 S.Ct. 1945 (1980) 5, 6, 10, 11, 12
Chris Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2nd Cir.) cert. denied, 414 U.S. 910 (1973) 7
SEC v. Bausch & Lomb, 565 F.2d 8 (2nd Cir. 1977) ... 7
SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978) 7
SEC. v. Commonwealth Chemical Securities, Inc., 574 F.2d 90 (2nd Cir. 1978) 7
SEC v. Geon Industries, Inc., 531 F.2d 39 (2nd Cir. 1976) 7
SEC v. Greenspan, [1979 Transfer Binder] Fed.Sec.L.Rpts. (CCH) ¶ 96, 747 (S.D. N.Y. 1978) 6
SEC v. Lummis [1977-78 Transfer Binder] Fed.Sec.L.Rpts. (CCH) ¶ 19, 245 (N.D. Cal. 1977) 10
SEC v. Manor Nursing Centers, Inc., 455 F.2d 1082 (2nd Cir. 1972) 7
SEC v. Monarch Fund, 608 F.2d 938 (2nd Cir. 1979) 10
SEC v. Warren, 589 F.2d 115 (3d Cir. 1978) 6, 10

Statutes

28 U.S.C.A. § 1345 (West 1966) 3
28 U.S.C.A. § 1254(1) (West 1966) 2
15 U.S.C.A. § 78u (Securities Exchange Act of 1934, § 21(d)) (West 1981) 2, 3, 5, 6
15 U.S.C.A. § 78j (b) (Securities Exchange Act of 1934, § 10(b)) (West 1981) 3, 5, 10, 11
17 C.F.R. 240.10b-5 (SEC Rule 10b-5) (1981) 3, 10
Federal Rule of Civil Procedure, 9 11
Federal Rule of Civil Procedure, 36 4

Other Authority

House of Representatives Report No. 299, 94th Cong., 1st. Sess., 66-67 (1975) 7

No. 81-.....

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

JOSEPH D. UNDERWOOD

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, FIFTH CIRCUIT

Petitioner, Joseph D. Underwood respectfully prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals, Fifth Circuit entered in this proceeding on July 16, 1981.

OPINIONS BELOW

The opinion of the United States Court of Appeals, Fifth Circuit in this case, printed in the appendix, infra, is not yet reported. The judgment of the United States District Court, Northern District of Texas, was rendered without opinion.

JURISDICTION

Judgment of the United States Court of Appeals, Fifth Circuit, printed in the appendix, was entered on July 16, 1981, and this Petition for Writ of Certiorari was filed within ninety (90) days of that date. The jurisdiction of this court is invoked under 28 U.S.C.A. § 1254(1) (West 1966).

QUESTIONS PRESENTED

(1) Whether prior securities violations alone, in the face of the lengthy lapse of time between the alleged violations and the summary judgment, the change of circumstances imposed by the Securities and Exchange Commission (herein "SEC"), and the admission by the SEC that there exists no proof of continuing violations, satisfy the requirements of Section 21(d) of the Securities Exchange Act of 1934 (herein "Exchange Act") for issuance of an injunction.

(2) Whether the complaint in this case filed by the SEC pursuant to Section 21(d) of the Exchange Act (alleging violations of Section 10-b of the Exchange Act), must contain specific allegations of intentional wrongdoing — scienter — after *Aaron v. SEC.*

STATUTE INVOLVED

Section 21(d) of the Exchange Act, 15 U.S.C.A. § 78u (West 1981), states in pertinent part:

> (d) Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder . . . it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper show-

ing a permanent or temporary injunction or restraining order shall be granted without bond.

STATEMENT OF CASE

On August 19, 1977 the SEC filed its Complaint against Zale Corporation and various individuals, including the Petitioner, Joseph D. Underwood (herein, "Underwood"). The Complaint (all relevant portions of which are appended to the opinion of the Fifth Circuit, printed infra) basically alleged that Underwood aided and abetted various violations of the anti-fraud provisions of the Exchange Act, as amended, during a period ending in March 1975. Jurisdiction was based on 25 U.S.C.A. § 1345 (West 1966). Pursuant to its authority under Section 21(d) of the Exchange Act, 15 U.S.C.A. § 78u (West 1981), the SEC sought injunctive relief against Underwood and others for future violations of Section 10(b) of the Exchange Act, 15 U.S.C.A. § 78j(b) (West 1981), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5 (1980).

On September 15, 1977, Underwood filed his Motion to Dismiss the SEC's Complaint alleging among other things that the SEC failed to state a claim upon which relief could be granted, that it did not allege intentional violative conduct ("scienter") and further, that the requirements of Section 21(d) of the Exchange Act had not been met by the SEC. Subsequently, the District Court directed that Underwood deliver to the SEC various documentary evidence, which the SEC had requested and had hoped would establish a likelihood of recurring violations by Underwood.

During a conference in chambers with the District Court, attorneys for the SEC admitted that the SEC had no information or evidence of any alleged violative conduct by Underwood since March, 1975. This admission was formal-

ized by the SEC's failure to respond to a Request for Admissions submitted to it pursuant to Rule 36 of the Federal Rule of Civil Procedure. In May, 1978, Underwood and the SEC filed cross-motions for summary judgment and on August 24, 1978 the District Court granted summary judgment in favor of Underwood. The SEC appealed the judgment to the Fifth Circuit which reversed and remanded the cause for further proceedings.

In remanding, the Fifth Circuit reasoned that past conduct alone created a sufficient inference of future wrongdoing to justify denial of Underwood's motion for summary judgment and to meet the "proper showing" requirement of Section 21(d) of the Exchange Act. The Fifth Circuit then held that Underwood had not shown that present conditions sufficiently negated the likelihood of future violations as to overcome the aforementioned inference. In its opinion, the Fifth Circuit explicitly or implicitly rejected the following factors advanced by Underwood in support of the District Court's decision:

> (1) The SEC admitted that Underwood had not engaged since at least March 1975, and is not now engaged nor about to be engaged in activity which would be violative of the Exchange Act, Record Vol. I, all, p.3
>
> (2) Zale Corporation and its executives had already consented to injunctions and had agreed to take a series of steps precluding the recurrence of the conduct which the SEC alleged amounted to Exchange Act violations. Record Vol. I, pp.23-40.
>
> (3) Underwood's alleged involvement in the violations described in the Complaint demonstrated that Underwood was not a principal in the alleged violations, but, at most, an alleged aider and abettor therein.
>
> (4) Changes in the tax laws make impossible a repeat of the types of violations alleged by the SEC.

(5) Underwood, as Assistant Treasurer of Zale Corporation, is not in a position to undertake personally to involve the corporation in future securities laws violations.

(6) By the time the SEC filed its Complaint, more than two years had passed since Underwood had ceased his alleged violative activities; another year passed before the District Court granted summary judgment in favor of Underwood; almost another three years passed before the Fifth Circuit reversed and remanded the case; by the time the case is decided in the District Court upon remand, if the case is eventually remanded, a full seven years or more will have passed since Underwood ceased his allegedly violative conduct.

REASONS FOR GRANTING THE WRIT

1. The decision of the Fifth Circuit conflicts with decisions in the Fifth and other Circuits, and guidance from this Court is needed to assist the lower federal courts in the determination and application of the correct legal standards for the maintenance of actions by the SEC under Section 21(d) of the Exchange Act.

(a) *SEC injunctive actions are of grave importance both to the SEC and those it seeks to enjoin.*

The injunctive power of the SEC as conferred by Section 21(d) of the Exchange Act to enjoin violations of Section 10(b) of the Exchange Act is one of the chief means by which the SEC can and does seek protection against deception in the marketplace. As a result it is one of the key weapons in the statutory arsenal for insuring market integrity and investor confidence. *Aaron v. SEC* 446 U.S. 680, 100 S.Ct. 1945, 1959 (1980) (Blackmun J., dissenting). As demonstrated by the instant case, in which the alleged securities violations in essence stem from alleg-

ed tax violations, the SEC's use of its injunctive powers is frequent and widespread.

As Chief Justice Burger noted in *Aaron*, injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith. 100 S.Ct. at 1959 (Burger, C. J., concurring). The imposition of an injunction not only damages the enjoined party's business reputation, it also exposes him to criminal and civil liabilities that would not otherwise exist. *See, e.g., SEC v. Warren*, 583 F.2d 115 (3rd Cir. 1978). For example, in *SEC v. Greenspan*, [1979 Transfer Binder] Fed. Sec.L.Reptr. (CCH) ¶ 96,747 (S.D.N.Y. 1978), the District Court allowed the SEC to proceed with a criminal contempt proceeding based on alleged violations of a civil injunction entered eighteen years before. Obviously, a clear and precise determination of the correct legal principles to apply in SEC injunctive cases is of paramount importance both to the SEC and to those individuals and entities whom it seeks to enjoin.

(b) *The opinion of the Fifth Circuit below conflicts with other appellate decisions, including its own, by applying an incorrect standard for the "proper showing" required by Section 21(d).*

Section 21(d) of the Exchange Act enables the SEC to seek injunctive relief against any person upon a "proper showing" that that person "is engaged or is about to engage in acts or practices constituting the violation of any provision of this title." In its reversal of the summary judgment granted by the District Court, the Fifth Circuit effectively reached two conclusions. First, it concluded that the alleged prior violations, standing alone with no proof of recent past, current or prospective violations, could satisfy the mandate of Section 21(d). Second, the court concluded that Underwood's affirmative demonstration of the unlikelihood, if not impossibility, of present or future violations of the securities laws did not entitle him to summary judgment. Both conclusions conflict with other appellate decisions.

(i) The alleged prior violations, standing alone, cannot justify an injunction.

The SEC's Complaint, alleging prior securities law violations, without more, does not justify issuance of an injunction, nor does it evidence a likelihood of violative activity in the future. *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978); *ChrisCraft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2nd Cir.), cert. denied, 414 U.S. 910 (1973). In order to state a claim upon which injunctive relief can be granted, the SEC must establish a reasonable likelihood that the asserted wrong will be repeated. *Blatt*, 583 F.2d at 1334, *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 56 (2nd Cir. 1976); *SEC v. Bausch & Lomb*, 565 F.2d 8 (2nd Cir. 1977); *Chris Craft Industries*, 480 F.2d at 394, *SEC v. Manor Nursing Centers, Inc.*, 455 F.2d 1082 (2nd Cir. 1972). In short, "the Commission needs to go beyond the mere fact of past violations." *SEC v. Commonwealth Chemical Securities Inc.*, 574 F.2d 90, 99-100 (2nd Cir. 1978).

This case represents an attempt by the SEC to accomplish through the courts that which it could not accomplish through the normal legislative process. As noted, Section 21(d) of the Exchange Act requires a "proper showing" the defendant "is engaged" or "is about to engage" in violative conduct. In an attempt to expand the scope of injunctive relief beyond the statutory language requiring current or prospective securities violations and to establish that proof of a prior violation would automatically support the issuance of an injunction, the SEC in 1975 attempted to amend the Exchange Act. H.R. Rep. No. 299, 94th Cong., 1st Session, 66-67, 1975.

The attempted amendment was in response to the denial of injunctive relief where the SEC had proved past violations in *Chris Craft Industries, supra.* Recognizing that Section 21(d) as written did not make proof of past violations a determinative factor, the SEC sought to add the

words "has engaged" to "is engaged or about to be engaged," and to change the requirement of a "proper showing" to one of "such showing." The proposed amendment resulted in such vigorous opposition from the bar though that the House-Senate Conference Committee decided to drop it.

The effect of the Fifth Circuit's opinion is to grant the SEC the amendment the legislature refused it. In the instant case, the District Court gave the SEC every opportunity to discover and offer evidence beyond the prior violations to prove that Underwood was a candidate for future violations of the securities laws. Nonetheless, the SEC failed to offer, indeed admitted that it did not have, a shred of evidence beyond the claim of violations that had admittedly ceased two years before the Complaint was filed. Accordingly, the District Court knew that whether the case was presented to it by summary judgment or by trial on the merits it would have no evidence presented to it beyond that of past violations.

The District Court was within its discretion to grant the summary judgment. The Fifth Circuit's reversal of that summary judgment was both in error and in conflict with the case law discussed above.

(ii) The Fifth Circuit improperly rejected the affirmative defensive arguments presented by Underwood.

In support of his Motion for Summary Judgment, Underwood presented to the District Court various affirmative reasons demonstrating the unlikelihood that he would ever in the future commit violations of the securities laws. First, Underwood is the assistant treasurer of Zale Corporation, a position of responsibility, but not of policy making. Even in the SEC's Complaint, Underwood appears only as one who aided and abetted his superiors, and never since the time of the alleged prior violations has Underwood been in a position to commit any such violations by his own independent decision.

Under the circumstances, the SEC's claim for relief would be misdirected even if based on something more compelling than past violations. Moreover, Zale Corporation and its principal officers are now bound by consent to an injunction preventing them from initiating any conduct violative of the securities or tax laws. Underwood is thereby effectively precluded from being involved in any such scheme. An injunction against Underwood is unwarranted under these circumstances and does nothing to safeguard the securities market.

Not only would it be practically impossible for Underwood to initiate or abet any violation, it would be pointless. The District Court properly considered how tax laws have been changed since the prior alleged violations. The tax benefits allegedly sought and improperly obtained by Zale Corporation by the alleged past violations are no longer available. Therefore, future violations of the kind alleged by the SEC are indeed impossible.

Another significant factor properly considered by the District Court and improperly ignored by the Fifth Circuit was the considerable lapse of time between the time the alleged violations had admittedly ceased and the filing of the Complaint. More than two years passed after the cessation of the alleged activities before the SEC sought an injunction. Another year passed before the District Court granted summary judgment and almost another three years passed before the Fifth Circuit issued its opinion. By the time this Petition is considered by this Court, more than six and one-half years will have passed since the last act complained of and there is not a shred of evidence that Underwood has engaged in any culpable or violative conduct in that six and one-half years. Nonetheless the SEC continues to press a suit with serious consequences for Underwood, based on a now long dead past.

All of the above considerations supporting the District Court's decision were rejected without due consideration by the Fifth Circuit despite the weight given them in other Circuits. In *SEC v. Warren*, 583 F.2nd 115, 121 (3rd Cir. 1978) the Third Circuit recognized that situations may exist where a change in regulations diminishes the need for administrative enforcement by contempt. A Ninth Circuit District Court has recognized that a change in the defendant's position may make injunction unnecessary. *SEC vs. Lummis*, [1977-78 Transfer Binder] Fed.Sec.L.Rpts. (CCH) ¶96,245 (N.D.Cal. 1977) ("The unique circumstances which led to Defendant's violation in 1968 no longer exist.") These courts and cases also considered the lapse of time since the last alleged violation to be important. *Warren*, 583 F.2d at 122, *Lummis*, [1977-78] Transfer Binder] Fed.Sec.L.Rptr. (CCH), at p. 92, 639. In *SEC v. Monarch Fund*, 608 F.2nd 938, 943 (2nd Cir. 1979), the Court said that an injunction would not be appropriate where judgment was not entered until more than seven years after the alleged violations and where the SEC conceded there was no evidence of the Defendant's prior or subsequent violations of the securities laws. If this case is remanded to the District Court, any further proceedings will not occur until more than seven years since the last alleged violative conduct. The Fifth Circuit's failure to consider and uphold the District Court's reliance on changed circumstances, changed tax law, and lapse of time conflicts with what is clearly the law in other Circuits, and so deserves the scrutiny of this Court.

2. The failure of the SEC to allege scienter in its Complaint conflicts with the rule of *Aaron v. SEC*.

In *Aaron v. SEC*, 446 U.S. 680, 100 S.Ct. 1945 (1980) this Court squarely addressed the necessity of alleging and proving scienter or intentional misconduct in SEC injunctive actions. The Court held that with respect to injunctions sought to prevent violations of Section 10b of, and Rule

10b-5 under, the Exchange Act, allegations and proof of scienter are absolutely required.

The SEC's Complaint was filed in this case prior to the announcement of the opinion in *Aaron* and at a time when the SEC was taking the position that scienter was not a necessary element of a Section 10b injunction action. After the announcement of *Aaron*, the SEC, without amending its Complaint, constructed an argument that the necessary allegations of intent were present in it. Although the Fifth Circuit accepted the SEC's new position, this Court can determine from the Complaint that the requirements of *Aaron* are not met. The Complaint against Underwood merely tracked some of the relevant statutory language; it did not allege that Underwood's conduct was intentional, willful or perpetrated with scienter even in the general form permitted by Rule 9(b) of the Federal Rules of Civil Procedures.

In injunction cases, where the granting of the requested relief may subject the enjoined party to contempt and criminal sanctions, pleading requirements become especially important. The failure of the complaint to meet the requirements of *Aaron* alone justified summary judgment in Underwood's favor.

CONCLUSION

In overruling the District Court's grant of summary judgment in favor of Underwood the Fifth Circuit adopted a position in conflict both with the other Courts of Appeal and this Court's decision in *Aaron*. For these reasons, a Writ of Certiorari should be issued to review the judgment and opinion of the United States Court of Appeals, Fifth Circuit.

Respectively submitted,

DURANT, MANKOFF, DAVIS,
WOLENS & FRANCIS

Joel Held
Bruce A. Budner
Attorneys for Petitioner

SECURITIES & EXCHANGE COMMISSION
v.
ZALE CORPORATION

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,

v.

ZALE CORPORATION, et al.,
Defendants-Appellees.

No. 78-3381

United States Court of Appeals,
Fifth Circuit.
Unit A

July 16, 1981.

The Securities and Exchange Commission brought suit against corporation and several of its officers to establish past violations and enjoin future violations of the securities laws. The United States District Court for the Northern District of Texas, William M. Taylor, Jr., J., entered orders of permanent injunction against all defendants except two officers. The Court granted the officers' motions for summary judgment. Appeal was taken. The Court of Appeals, Thornberry, Circuit Judge, held that: (1) the Commission is entitled to prevail when the inferences flowing from the defendants' prior illegal conduct, viewed in light of present circumstances, betoken a reasonable likelihood of future transgressions; (2) the fact that one officer was no longer employed by the corporation was not sufficient to defeat injunctive relief without a showing of how that change necessarily rendered it unreasonable to expect future violations; and (3) conditions imposed upon the corporation pursuant to consent judgments were insufficient to defeat injunctive relief.

Reversed and remanded.

1. Securities Regulation (Key) 174

In action by Securities and Exchange Commission to enjoin future violations of securities laws based on allegations that corporate officers repeatedly defrauded government out of millions of dollars in tax revenues by illegally manipulating fund transfers among subsidiaries of corporation, SEC was not required to use word "scienter" in its complaint in order to state cause of action, and, therefore, allegations that officers used "device, scheme and artifice to defraud" and that one officer, "aided and abetted" by another, "devised a scheme for manipulating financial records for the purpose of evading federal income taxes" were sufficient to suggest the theory of liability resting on intentional misconduct. Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

2. Securities Regulation (Key) 171

Although mere fact of past violation does not ipso facto establish Securities and Exchange Commission's right to injunctive relief, and thus is not alone tantamount to proper showing of present or future violations, Commission is entitled to prevail in action seeking permanent restraining order when inferences flowing from defendant's prior illegal conduct, viewed in light of present circumstances, betoken reasonable likelihood of future transgressions. Securities Act of 1933, § 20(b), 15 U.S.C.A. § 77t(b).

3. Securities Regulation (Key) 171

Relevant considerations in determining whether there is "reasonable likelihood" of future violations or transgressions of securities laws, so as to justify permanent restraining order, include nature of past violation, defendant's present attitude and objective constraints on or opportunities for future violations of securities laws; thus, it is not single factor, but rather sum of circumstances surround-

ing defendant and his past conduct that governs whether to grant or deny injunctive relief. Securities Act of 1933, § 20(b), 15 U.S.C.A. § 77t(b).

4. Securities Regulation (Key) 171

In action by Securities and Exchange Commission to enjoin future violations of securities laws based on allegations that corporate officers repeatedly defrauded government out of millions of dollars in tax revenues by illegally manipulating fund transfers among subsidiaries of corporation, fact that one officer no longer was employed by corporation was legally insufficient to defeat injunctive relief without detailed showing of how that change necessarily rendered it unreasonable to expect future violations. Securities Act of 1933, § 20(b), 15 U.S.C.A. § 77t(b).

5. Securities Regulation (Key) 171

In action by Securities and Exchange Commission to enjoin future violations of securities laws based on allegations that corporate officers repeatedly defrauded the government out of millions of dollars in tax revenues by illegally manipulating fund transfers among subsidiaries of corporation, evidence that conditions imposed on corporation pursuant to consent judgment would greatly impede future violations was insufficient to defeat injunctive relief, since, if officer used his expertise as certified public accountant to repeatedly and knowingly aid his superiors in defrauding public, then fact that ancillary SEC action would force him to act more circumspectly in future was not enough to countervail strong inference of future wrongdoing arising from his actions in past. Securities Act of 1933, § 20(b), 15 U.S.C.A. § 77t(b).

Appeal from the United States District Court for the Northern District of Texas.

Before THORNBERRY, COLEMAN and AINSWORTH, Circuit Judges.

THORNBERRY, Circuit Judge:

The Securities and Exchange Commission (SEC) brought suit against Zale Corporation and several of its officers to establish past violations and to enjoin future violations of the securities laws. The district court entered orders of permanent injunction by consent against all defendants except appellees Sol Shearn Rovinsky and Joseph D. Underwood. The court granted their motions for summary judgment, concluding as a matter of law that the SEC was not entitled to obtain a permanent injunction against them. We conclude that summary judgment was inappropriate in this instance and accordingly reverse the judgment below and remand for further proceedings.

[1] In essence, the SEC's complaint alleges in relevant part that during a period spanning some six years, Mr. Rovinsky, aided principally by Mr. Underwood, repeatedly defrauded the government out of millions of dollars in tax revenues by illegally manipulating fund transfers among Zale subsidiaries.[1] The corollary of their alleged accounting sleight of hand was the misleading overstatement of earnings per share in Zale's financial statements. The SEC's position is that the egregious and recurrent character of these alleged violations of the antifraud provisions of the securities laws,[2] if proved, would alone warrant the award of injunctive relief against these defendants. Appellees contend that changed circumstances render it unreasonable to expect that violations, if they occurred in the past, will occur again.

---

[1] Those counts in the complaint pertaining to these defendants are set forth in the appendix to this opinion.

[2] In particular, section 10(b) of the Securities and Exchange Act of 1934, as amended, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. Although the Supreme Court has held that the SEC is required to establish scienter as an element of a civil enforcement action to enjoin violations of section 10(b) and Rule

I.

[2] Section 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b), and section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d), authorize the Commission to seek and direct the courts to enter permanent restraining orders upon a "proper showing" that the defendant "is engaged or is about to engage" in violations of the securities laws. Although the mere fact of a past violation does not ipso facto establish the SEC's right to injunctive relief, and thus is not alone tantamount to the "proper showing" of present or future violations, the Commission is entitled to prevail when the inferences flowing from the defendant's prior illegal conduct, viewed in light of present circumstances, betoken a "reasonable likelihood" of future transgressions. *See, e. g., SEC v. Murphy,* 626 F.2d 633 (9th Cir.1980); *SEC v. Bonastia,* 614 F.2d 908 (3rd Cir.1980); *SEC v. Caterinicchia,* 613 F.2d 102 (5th Cir.1980); *SEC v. Blatt,* 583 F.2d 1325 (5th Cir.1973); *SEC v. Koracorp Industries,* 575 F.2d 692 (9th Cir.1978).

[3] Relevant considerations in the "reasonable likelihood" analysis resolve into essentially three areas of inquiry: the nature of the past violation, the defendant's present attitude, and objective constraints on (or opportunities for) future violations of the securities laws. *See, e. g., SEC v. Murphy, supra,* at 655; *SEC v. Bonastia, supra,* at 912. As we stated in *SEC v. Blatt, supra,* at 1334 n.29:

10b-5, *Aaron v. SEC,* 446 U.S. 680 (1980), we reject appellee Underwood's contention that the SEC is therefore required to use the word "scienter" in its complaint in order to state a cause of action. The SEC's allegations here that both defendants employed a "device, scheme and artifice to defraud" and that Mr. Rovinsky, "aided and abetted" by Mr. Underwood, "devised a scheme for manipulating financial records for the purpose of evading federal income taxes" are sufficient to suggest a theory of liability resting upon intentional misconduct. *See Weissbuch v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 558 F.2d 831, 833 (7th Cir.1977).

> Such factors include the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Thus, it is not a single factor, but rather the sum of the circumstances surrounding the defendant and his past conduct that governs whether to grant or deny injunctive relief.

II.

In granting defendants' motions for summary judgment in this instance, and thus in concluding that they succeeded in proving the absence of any genuine issue of fact material to judgment in their favor, the district court assumed for purposes of his ruling that past violations occurred.[3] However, since injunctions have repeatedly been granted in cases presenting less significant prior violations than those assumed to have occurred in this instance, *see, e. g., SEC v. Blatt, supra,* we fail to understand how the court's assumption led to its conclusion. Since hypothesizing the existence of repeated willful violations of a consequential nature patently cannot help to establish the defendants' right to prevail here as a matter of law, the court must have relied on factors wholly independent of the character of the past conduct to reach its result.

---

[3] At the hearing on the motions for summary judgment, the district judge stated:

> I will assume for the sake of argument on the law that these are the facts that exist [that past violations occurred]. I am not going to find that, I am just assuming that in order to determine a question of law.

Record on Appeal, Vol. II, p. 34.

[4] With respect to Mr. Rovinsky, the only fact appearing in the record that could have influenced the court's decision, and the only one raised by Mr. Rovinsky in his motion for summary judgment, is the fact that he is no longer employed by Zale Corporation. But as the Third Circuit stated recently in *SEC v. Bonastia, supra*, at 913:

> Changed circumstances of the violator are relevant in determining whether an injunction shall issue, but a change in occupation, without more, will not provide a complete defense to an injunction suit.... The district court inexplicably ignored the recurrent nature of [the defendant's] violations and gave no weight to the inferences naturally drawn therefrom.

We agree that a change in occupation, without a detailed showing of how that change necessarily renders it unreasonable to expect future violations, is legally insufficient to defeat injunctive relief and thus, a fortiori, is insufficient to establish the moving party's right to summary judgment. *See SEC v. Koracorp Industries, supra.*

[5] Although it is more difficult to discern the exact basis for the court's judgment in favor of Mr. Underwood, the only relevant factor raised in his motion for summary judgment of any persuasiveness is that the conditions imposed on Zale Corporation pursuant to the consent judgment would greatly impede future violations.[4] We cannot agree, however, that this hindering circumstance is sufficient to affirm summary judgment in this instance. If Mr. Underwood, as the court apparently assumed, used his expertise as a certified public accountant to repeatedly and knowingly

---

[4] Zale Corporation consented to, inter alia, electing three independent members to its Board of Directors, reconstituting the Audit Committee so as to give the independent directors a majority, and adopting a "Code of Ethical Standards and Business Practices." *See* Record on Appeal, Vol. 1, pp. 32-39.

aid his superiors in defrauding the public, then the fact that ancillary SEC action will force him to act more circumspectly in the future is simply not enough to countervail the strong inference of future wrongdoing arising from his actions in the past. This is particularly true when, as here, the defendant admits to no wrongdoing, but rather continues to profess that he was merely the unwitting participant in someone else's scheme. *See, e. g., SEC v. Murphy, supra.*

Thus, concluding that the defendants were not entitled to judgment as a matter of law given the court's assumption that both engaged in serious, recurrent wrongdoing and that triable issues of fact remain, we REVERSE the entry of summary judgment in their favor and REMAND the causes for further proceedings consistent with this opinion.[5]

---

[5] Several miscellaneous points require brief mention. First, it is clear that the court erred during the hearing on the cross motions for summary judgment in characterizing the statutory injunction at issue as "extraordinary relief." *See, e.g., SEC v. Caterinicchia, supra,* at 105. Second, we find no merit to appellee Underwood's argument that the SEC's failure to answer requests for certain admissions (concerning the lack of evidence – beyond that attendant to the past violations – that Mr. Underwood was engaged or about to engage in violations of the securities laws) establishes his right to summary judgment. These admissions leave unaffected the question presented in this case: were the past violations of sufficient gravity to warrant a controlling inference of future misconduct? Third, since Mr. Rovinsky, unlike Mr. Underwood, apparently does not dispute his participation in the scheme detailed in the SEC's complaint, the SEC asks us to go beyond reversal of summary judgment in his case and direct that he be permanently enjoined. We decline to do so, however, because, due to the fact that he has not directly participated in this appeal, we have insufficient information concerning his present circumstances to make such a ruling.

APPENDIX

COUNT II

Violations of Section 10(b), Securities Exchange Act of 1934, as amended [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. 240.10b-5] — Fraud in the Purchase and Sale of Securities

17. Plaintiff re-alleges and incorporates by reference each and every allegation contained in paragraphs 1 through 16 of this complaint.

18. Since on or about January 1, 1970, the Defendants ZALE CORPORATION, SOL SHEARN ROVINSKY, JOSEPH D. UNDERWOOD and RONNIE JOE HICKERSON, by use of means and instrumentalities of interstate commerce and of the mails, have been, directly and indirectly employing a device, scheme and artifice to defraud, making untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and engaging in acts, practices and a course of business which operates and would operate as a fraud and deceit upon certain persons in connection with the purchase and sale of certain securities, namely, the common and preferred stock and commercial paper issued by ZALE CORPORATION, in the manner and by the means set forth in paragraphs 19 and 20 herein, all in violation of Section 10(b) of the Securities Exchange Act of 1934, as amended [15 U.S.C. 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. 240.10b-5].

19. As part of and in furtherance of the aforesaid conduct:

a. In early 1970, SOL SHEARN ROVINSKY devised a scheme for manipulating the financial records of ZALE CORPORATION for the purpose of evading federal income taxes.

b. The object of the manipulation was to cause the maximum corporate surtax exemption to appear to be available for each of ZALE CORPORATION's hundreds of subsidiaries which, prior to 1976, filed separate federal tax returns. It also had the effect of taking maximum advantage of net loss carry-forwards.

c. The scheme was accomplised by misallocating income and expenses between subsidiary corporations in the following ways:

(1) Sufficient income was funnelled from operating stores into closed stores to take advantage of net loss carry-forwards and to take advantage of the surtax exemption;

(2) Expenses of marginal stores were credited and charged to highly profitable stores;

(3) Income and expense items which could be legally allocated among the various subsidiaries were manipulated to load the profitable stores with expense, while income was allocated to poor stores.

d. Procedures (1) and (2) set forth in paragraph c above were implemented by ROVINSKY making hand journal entries. In procedure (3), ROVINSKY was aided and abetted by JOSEPH D. UNDERWOOD and RONNIE JOE HICKERSON.

e. For the fiscal year ended March 31, 1970, the scheme was implemented by Rovinsky alone. For approximately three days during each year-end closing for the years 1971 through 1975, ROVINSKY, aided and abetted by UNDERWOOD and HICKERSON, in the procedure described in paragraph 19.c.(3) above, acting together, would manually indicate on computer cards changes to be made in allocations of income and expense. The cards would then be returned to the data

processing department where the indicated changes would be programmed into the computer.

f. As a result of the manipulative procedures described in paragraphs c, d, and e above which were instituted by ROVINSKY and carried out by him, and aided and abetted by UNDERWOOD and HICKERSON, in the procedure described in paragraph 19.c.(3) above, the financial statements for ZALE CORPORATION included in its Form 10-K and Form 10-Q filings and proxy solicitations for the period March 31, 1970 to February 1976 did not accurately reflect the true tax liability of ZALE CORPORATION, thereby causing earnings per share to be overstated.

20. In connection with the device, scheme and artifice to defraud, the Defendants, ZALE CORPORATION and SOL SHEARN ROVINSKY, singly and in concert, aiding and abetting each other, as set forth in paragraph 19 above, and the Defendants, ZALE CORPORATION and SOL SHEARN ROVINSKY, aided and abetted by the Defendants, JOSEPH D. UNDERWOOD and RONNIE JOE HICKERSON, as set forth in paragraph 19.c.(3) above, in connection with the purchase and sale of common and preferred stock and commercial paper issued by ZALE CORPORATION, omitted to state material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading, including, but not limited to, the following:

a. The financial records of ZALE CORPORATION were distorted as a result of the misallocation of income and expense items between subsidiary corporations.

b. The misallocations resulted in the understatement of federal income tax liability and the over-statement

of earnings in the financial statements of ZALE CORPORATION.

c. ZALE CORPORATION subsidiaries filed federal tax returns which did not accurately reflect their taxable income or tax liability.

• • • • • •

COUNT IV

Violations of Section 13(a), Securities Exchange Act of 1934, as amended [15 U.S.C. § 78m(a)] and Rule 12b-20 thereunder [17 C.F.R. 240.12b-20] — Failure to Include Material Information in Periodical Reports

23. Plaintiff re-alleges and incorporates by reference each and every allegation contained in paragraphs 1 through 22 of this Complaint.

24. Since on or about January 1, 1970, the Defendant, ZALE CORPORATION, aided and abetted by SOL SHEARN ROVINSKY, JOSEPH D. UNDERWOOD and RONNIE JOE HICKERSON, has filed with the Plaintiff, SECURITIES AND EXCHANGE COMMISSION, Forms 10-K, Forms 10-Q and Forms 8-K which failed to disclose material information necessary to make the required statements, in light of the circumstances under which they were made, not misleading, as set forth in paragraphs 19 and 20 of Count II of this Complaint.

• • • • • •

COUNT VI

Violations of Section 14(a), Securities Exchange Act of 1934, as amended [15 U.S.C. § 78n(a)] and Rule 14a-9 thereunder [17 C.F.R. 240.14a-9] — Fraud in the Solicitation of Proxies

27. Plaintiff re-alleges and incorporates by reference each and every allegation contained in paragraphs 1 through 26 of this Complaint.

28. Since on or about January 1, 1970, the Defendant, ZALE CORPORATION, aided and abetted by SOL SHEARN ROVINSKY, JOSEPH D. UNDERWOOD and RONNIE JOE HICKERSON, has by use of the mails and means and instrumentalities of interstate commerce, made solicitations by means of proxy statements to shareholders of ZALE CORPORATION, which proxy statements failed to disclose material facts necessary in order to make the statements therein not false or misleading, as set forth in paragraphs 19 and 20 of Count II of this Complaint.

Opposition

Office - Supreme Court, U.S.
FILED
NOV 20 1981
ALEXANDER L. STEVAS,
CLERK

No. 81-766

In the Supreme Court of the United States

OCTOBER TERM, 1981

JOSEPH D. UNDERWOOD, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

EDWARD F. GREENE
General Counsel

JACOB H. STILLMAN
Associate General Counsel

ROSALIND C. COHEN
Assistant General Counsel

LOUIS C. WHITSETT
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

QUESTIONS PRESENTED

1. Whether the court of appeals erred in reversing the grant of summary judgment in favor of a defendant in an action brought by the Securities and Exchange Commission to enjoin violations of the federal securities laws, when the Commission had alleged, and the district court had assumed for the purpose of its ruling, that the defendant, a certified public accountant, repeatedly had aided and abetted a scheme to manipulate the financial records of a publicly-held corporation, resulting in material misstatements in the company's audited financial statements.

2. Whether a complaint filed by the Securities and Exchange Commission, alleging that a defendant aided and abetted violations of the antifraud provisions of Section 10(b) of the Securities and Exchange Act and Rule 10b-5 thereunder, fails to allege that the defendant acted with scienter, when the complaint tracks the language of Rule 10b-5, stating that he "employ[ed] a device, scheme and artifice to defraud," and sets forth the fraudulent activities engaged in by that defendant and others.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	12

TABLE OF AUTHORITIES

Cases:

Aaron v. *SEC*, 446 U.S. 680	10
Boys Markets, Inc. v. *Retail Clerks Union, Local 770*, 398 U.S. 235	9
Brotherhood of Locomotive Firemen & Enginemen v. *Bangor & Aroostook R.R.*, 389 U.S. 327	7
Ernst & Ernst v. *Hochfelder*, 425 U.S. 185	10-11
Hamilton Shoe Co. v. *Wolf Brothers & Co.*, 240 U.S. 251	7
Herzfeld v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27	12
SEC v. *Aaron*, 605 F.2d 612, rev'd on other grounds, 446 U.S. 680	8
SEC v. *Blatt*, 583 F.2d 1325	5, 8
SEC v. *Bonastia*, 614 F.2d 908	8
SEC v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90	9
SEC v. *First American Bank & Trust Co.*, 481 F.2d 673	8
SEC v. *Haswell*, 654 F.2d 698	8
SEC v. *Keller Corp.*, 323 F.2d 397	8
SEC v. *Koracorp Industries, Inc.*, 575 F.2d 692, cert. denied, 439 U.S. 953	8, 10
SEC v. *Lummis*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,245	10
SEC v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082	8
SEC v. *Monarch Fund*, 608 F.2d 938	10

Cases—Continued

	Page
SEC v. *Murphy*, 626 F.2d 633	8
SEC v. *Savoy Industries, Inc.*, 587 F.2d 1149, cert. denied, 440 U.S. 913	8
SEC v. *Warren*, 583 F.2d 115	10
United States v. *Gleason*, 616 F.2d 2, cert. denied, 444 U.S. 1082	11, 12
Weissbuch v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831	12

Statutes and rules:

Securities Act of 1933, 15 U.S.C. (& Supp. III) 77a *et seq.*:	
Section 20(b), 15 U.S.C. 77t(b)	9
Securities Exchange Act of 1934, 15 U.S.C. (& Supp. III) 78a *et seq*:	
Section 10(b), 15 U.S.C. 78j(b)	2, 10, 12
Section 13(a), 15 U.S.C. 78m(a)	2
Section 14(a), 15 U.S.C. 78n(a)	2
Section 21(d), 15 U.S.C. 78u(d)	5, 7, 9
Rules under the Securities Exchange Act of 1934:	
Rule 10b-5, 17 C.F.R. 240.10b-5	2, 6, 10
Rule 12b-20, 17 C.F.R. 240.12b-20	2
Rule 14a-9, 17 C.F.R. 240.14a-9	2

Miscellaneous:

H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. (1975)	9
S. Rep. No. 1756, 86th Cong., 2d Sess. (1960)	9

In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-766

JOSEPH D. UNDERWOOD, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1 to A-8) is reported at 650 F.2d 718. The order of the district court is unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 16, 1981. The petition for a writ of certiorari was filed on October 13, 1981. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On August 19, 1977, the Securities and Exchange Commission filed a complaint in the United States District Court for the Northern District of Texas against petitioner, Joseph D. Underwood, and others [1] seeking to enjoin them from violating and aiding and abetting violations of antifraud, proxy and periodic reporting requirements of the federal securities laws.[2] The complaint alleged that petitioner Underwood, a certified public accountant and the assistant treasurer of Zale Corporation ("Zale"), aided and abetted a scheme to manipulate the financial records of Zale, a publicly-held company whose securities are traded on the New York Stock Exchange (Complaint ¶¶ 6, 11, 18, 19).[3] Although devised to avoid payment of federal income taxes, the scheme resulted in the material misstatement of Zale's earnings and earnings per share in audited financial statements filed with the Commission and disseminated to the public (Complaint ¶¶ 19, 22, 24, 28).

In particular, prior to 1976, Internal Revenue Service regulations permitted corporate subsidiaries

---

[1] Also named in the complaint were the Zale Corporation and five other individual defendants. On the date the suit was filed, the district court entered orders of permanent injunction by consent with respect to Zale Corporation and four of the six individual defendants.

[2] See Sections 10(b), 13(a), and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), 78m(a) and 78n(a); and Rules 10b-5, 14a-9 and 12b-20 thereunder, 17 C.F.R. 240.10b-5, 240.14a-9 and 240.12b-20.

[3] The court of appeals heard this case on the original record without an appendix. Citations to documents before the courts below, therefore, are to the original record.

to file separate returns and to utilize a surtax exemption that permitted them to be taxed at an extremely favorable rate on their first $25,000 of income. The Commission alleged that, in order for Zale to appear eligible to make maximum use of the surtax exemption and to utilize fully net loss carryforwards, petitioner Underwood and two other Zale employees would manually alter computer punch cards containing corporate financial data to reallocate income and expenses among Zale's more than 800 subsidiaries (Complaint ¶ 19). Specifically, the complaint alleged that, during an approximately three-day period at the corporation's year-end closings for each of the years 1971 through 1975, petitioner and his colleagues would allocate expenses of Zale's less profitable subsidiaries to profitable ones and income from profitable subsidiaries to subsidiaries which had gone out of business (*ibid.*). General corporate expenses and income likewise were reallocated among subsidiaries. The restated data were programmed into the company's computer and served as the basis for Zale's financial statements certified by its independent auditors (*ibid.*). The scheme came to light and was terminated only after Zale's treasurer was fired following the discovery of embezzlement from the company (Complaint ¶ 30).

2. Petitioner Underwood filed a motion for summary judgment in which he contended that irrespective of whether he committed violations of the federal securities laws in the past, the Commission could not meet its burden of showing a reasonable likelihood that he would do so in the future, as demonstrated by the Commission's concession—by virtue of not answering requests for admissions—that it knew of no specific evidence showing that petitioner *then* was

engaged or was about to engage in further violations of the Securities Exchange Act of 1934 or rules thereunder (Motion for Summary Judgment at 3-5). Another defendant, Zale's former treasurer, Sol Shearn Rovinsky, also moved for summary judgment.

The Commission filed a cross-motion for summary judgment along with a memorandum in response to the defendants' motions and in support of its own motion. The Commission cited evidence in the record concerning the aggravated nature of the illegal conduct and the willingness of petitioner, a certified public accountant and corporate financial officer, to participate repeatedly in a scheme to distort the books and records of a publicly-held corporation (Memorandum in Support of Plaintiff's Motion for Summary Judgment and in Response to Motions for Summary Judgment of Defendants Sol Shearn Rovinsky and Joseph D. Underwood at 2-4). This evidence consisted largely of the sworn testimony of petitioner Underwood and his colleagues, which included petitioner's own admission that essentially the misallocations were made by "three of us in the accounting department."[4] Notwithstanding its assumption for purposes of its ruling that petitioner Underwood had aided and abetted repeated violations of reporting, proxy and antifraud provisions of the federal securities laws, as alleged, the district court granted petitioner's motion for summary judgment.

---

[4] Transcript of Testimony of Joseph D. Underwood taken before the Securities and Exchange Commission on September 28, 1976 at 110 (referred to hereinafter as "Tr."). Petitioner also testified that the procedure did not seem unusual to him (Tr. 116); that he never asked about the basis of the allocations and did not think about their purpose (Tr. 117); and that he did not consider what he was doing to be a big event (Tr. 131).

3. The court of appeals reversed. In holding that the grant of summary judgment in favor of petitioner was unwarranted, the court of appeals pointed out that under Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d), courts are directed to enter an injunction upon a "proper showing" that the defendant "is engaged or is about to engage" in conduct in violation of the federal securities laws or Commission rules (Pet. App. A-5). In this connection, the court noted that the inquiry whether a defendant is likely to commit violations in the future involves an analysis of three subjects—"the nature of the past violation, the defendant's present attitude, and objective constraints on (or opportunities for) future violations of the securities laws" (*ibid.*). Thus, a court should take into account such factors as the

> egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Pet. App. A-6, quoting *SEC* v. *Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978). Accordingly, the court of appeals stated that a trial court must consider the totality of the circumstances (Pet. App. A-6). Although the existence of a past violation does not automatically entitle the Commission to injunctive relief, "the Commission is entitled to prevail when the inferences flowing from the defendant's prior illegal conduct, viewed in light of present circumstances, betoken a 'reasonable likelihood' of future transgressions" (*id.* at A-5).

The court of appeals observed that the district court, in granting summary judgment in favor of petitioner Underwood, assumed for the purposes of its ruling that petitioner had committed "repeated willful violations of a consequential nature" (Pet. App. A-6). Although the grant of that motion must, therefore, have rested on one or more mitigating factors, "[i]f Mr. Underwood * * * used his expertise as a certified public accountant to repeatedly and knowingly aid his superiors in defrauding the public," the entry of an injunction against the company —the only relevant factor of "any persuasiveness" raised by petitioner in support of his motion for summary judgment—is insufficient "to countervail the strong inference of future wrongdoing arising from his actions in the past" (*id.* at A-7 to A-8). The court added (*id.* at A-8):

> This is particularly true when, as here, the defendant admits to no wrongdoing, but rather continues to profess that he was merely the unwitting participant in someone else's scheme.

The court of appeals also rejected petitioner's contention that the Commission failed to state a cause of action under Rule 10b-5 by not using the word "scienter" in its complaint (Pet. App. A-4 to A-5 n.2). The court held that the Commission's statement of the cause, which tracked the language of the Rule and alleged, *inter alia*, that Zale's treasurer, aided and abetted by petitioner Underwood, "devised a scheme for manipulating financial records," was sufficient to show a theory of liability resting on intentional misconduct (*ibid.*).

Accordingly, the court of appeals reversed the grant of summary judgment in favor of petitioner and remanded the case for further proceedings.[5]

---

[5] The court of appeals also overturned the district court's grant of summary judgment in favor of defendant Rovinsky

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Review by this Court is not warranted.

1. The court of appeals in this case did not rule on the merits of the Commission's claims for injunctive relief against petitioner, but held only that the district court erred in concluding at this preliminary stage of the proceedings that such relief was unavailable as a matter of law. Because the Commission must still satisfy the statutory burden of showing entitlement to injunctive relief, consideration by this Court is not appropriate at this time. See *Brotherhood of Locomotive Firemen & Enginemen* v. *Bangor & Aroostook R.R.*, 389 U.S. 327 (1967); *Hamilton Shoe Co.* v. *Wolf Brothers & Co.*, 240 U.S. 251, 258 (1916).

2. Contrary to petitioner's argument (Pet. 7-8), a defendant's commission of past violations can form the basis of a "proper showing" for the entry of an injunction under Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d).[6] As the court

---

based on an affidavit stating only that he was no longer employed by Zale. In this connection, the court noted that a mere change in occupation, "without a detailed showing of how that change necessarily renders it unreasonable to expect future violations, is legally insufficient to defeat injunctive relief and thus, a fortiori, is insufficient to establish the moving party's right to summary judgment" (Pet. App. A-7).

[6] That Section provides in pertinent part:

> Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, [or] the rules or regulations thereunder, * * * it may in its discretion bring an action in the proper dis-

below recognized (Pet. App. A-8), this is particularly true where—as the Commission alleges here—the defendant has engaged in blatant and repeated violations of the Act.[7] Indeed, federal courts of appeals have concluded uniformly that past wrongdoing is highly significant in predicting the likelihood of future violations,[8] and many cases have held that such wrongdoing may give rise to an inference of future illegal conduct.[9]

---

trict court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

[7] Accord, *SEC* v. *Murphy*, 626 F.2d 633, 655 (9th Cir. 1980); *SEC* v. *Bonastia*, 614 F.2d 908, 912-913 (3d Cir. 1980); *SEC* v. *Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978).

[8] *SEC* v. *Haswell*, 654 F.2d 698, 699 (10th Cir. 1981); *SEC* v. *Aaron*, 605 F.2d 612, 624 (2d Cir. 1979), rev'd on other grounds, 446 U.S. 680 (1980); *SEC* v. *Bonastia*, *supra*, 614 F.2d at 912; *SEC* v. *Savoy Industries, Inc.*, 587 F.2d 1149, 1168 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979); *SEC* v. *Blatt*, *supra*, 583 F.2d at 1334; *SEC* v. *Koracorp Industries, Inc.*, 575 F.2d 692, 698-699 (9th Cir.), cert. denied, 439 U.S. 953 (1978); *SEC* v. *First American Bank & Trust Co.*, 481 F.2d 673, 682 (8th Cir. 1973); cf. *SEC* v. *Keller Corp.*, 323 F.2d 397, 402 (7th Cir. 1963) (injunction under Securities Act of 1933 and Investment Company Act of 1940). See also *Aaron* v. *SEC*, 446 U.S. 680, 701 (1980) (in showing that future violations may occur, "[a]n important factor * * * is the degree of intentional wrongdoing evident in a defendant's past conduct").

[9] *SEC* v. *Murphy*, *supra*, 626 F.2d at 655; *SEC* v. *Koracorp Industries, Inc.*, *supra*, 575 F.2d at 698; *SEC* v. *First American Bank & Trust Co.*, *supra*, 481 F.2d at 682; *SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972); *SEC* v. *Keller Corp.*, *supra*, 323 F.2d at 402.

Petitioner erroneously asserts (Pet. 7) that the fact that Congress declined to amend Section 21(d) to add the words "has engaged" to the statutory language "is engaged or is about to engage" demonstrates a congressional intent that active participation in egregious and repeated violations of the federal securities laws is legally insufficient to support the conclusion that a defendant is likely to violate those laws in the future. While congressional intent cannot normally be discerned from legislative inaction,[10] the House Conference Report with respect to the Securities Acts Amendments of 1975 expressly states that the additional language, which appeared in the Senate version of the bill, was considered unnecessary because "existing [case] law does not require clarification * * *."[11]

3. Petitioner cites (Pet. 8-10) several factors that, he claims, support his argument that he is unlikely to commit violations of the securities laws in the

---

[10] *Boys Markets, Inc.* v. *Retail Clerks Union, Local 770*, 398 U.S. 235, 241-242 (1970).

[11] H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 102 (1975). The legislative history with respect to an earlier proposal to amend the parallel provision of Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b), to add the words "has engaged" is also instructive. In discussing the proposed amendment, the Senate Report observed that, as demonstrated by the decisions of this Court and other federal courts, courts do consider past violations in determining whether such acts are likely to recur, and injunctive relief is not denied merely because the unlawful activity has ceased. S. Rep. No. 1756, 86th Cong., 2d Sess. 4 (1960). The Report concluded that the Committee agreed with existing case law in this area and that, therefore, the amendment—which the Commission had offered to "codify and clarify" the law—was unnecessary. *Ibid.* See *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 99 n.7 (2d Cir. 1978).

future: he is not in a policy-making position; Zale and its principal officers are now bound by a consent injunction preventing them from violating the securities laws; the tax laws have been changed to eliminate the multiple surtax exemption; and the Commission did not file its complaint until more than a year after the illegal scheme came to light. None of those factors, taken singly or in combination, supports the conclusion that petitioner is unlikely, as a matter of law, to commit further violations of the securities laws, notwithstanding the character of his past conduct and the inferences which may be drawn from that conduct. Cf. *SEC* v. *Koracorp Industries, Inc.*, 575 F.2d 692, 698-699 (9th Cir. 1978). Nor do any of the cases cited by petitioner (Pet. 10) hold to the contrary.[12] In none of them were circumstances of the sort relied on by petitioner deemed to be determinative, and the decisions in all of them turned on the existence of a number of mitigating factors not present here.

4. Petitioner's contention (Pet. 10-11) that the Commission's complaint fails to allege scienter—a necessary element in order to sustain a violation of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5—is likewise without merit. The Commission's complaint tracks the language of Rule 10b-5, alleging, *inter alia*, that petitioner and the other defendants "have been * * * employing a device, scheme and artifice to defraud * * *" (Pet. App. A-9). This Court in *Aaron* v. *SEC*, 446 U.S. 680, 689-691 (1980), and in *Ernst*

[12] *SEC* v. *Monarch Fund*, 608 F.2d 938 (2d Cir. 1979); *SEC* v. *Warren*, 583 F.2d 115 (3d Cir. 1978); *SEC* v. *Lummis*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,245 (N.D. Cal. 1977).

& *Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976), concluded that this language connotes a scienter requirement. Thus, as the court of appeals correctly determined (Pet. App. A-4 n.2), the Commission was not required to use the word "scienter" in its pleading.

The complaint in the present case alleges further that petitioner aided and abetted defendant Rovinsky in "a scheme for manipulating the financial records of Zale Corporation" by "misallocating income and expenses between subsidiary corporations." It also alleges that, in furtherance of the scheme, petitioner met with two other Zale employees at the end of each tax year at an approximately three-day session and at these meetings participated in

> manually indicat[ing] on computer cards changes to be made in allocations of income and expense. The cards would then be returned to the data processing department where the indicated changes would be programmed into the computer.

(Pet. App. A-10 to A-11.) Assuming the truth of these allegations, it is hardly credible that petitioner, a licensed CPA and financial officer of a publicly-held corporation, could not have known the nature and consequences of his activities.

In an analogous situation, the Second Circuit rejected a similar challenge based on the asserted failure of the government to plead scienter in a criminal action against bank officials who were charged with the commission of a fraudulent securities scheme. In that case, *United States* v. *Gleason*, 616 F.2d 2 (1979), cert. denied, 444 U.S. 1082 (1980), the court held that all the elements of the crime, including scienter, were properly alleged where "each count of the indictment followed the precise language of

§ 10(b)" and the indictment "specified the nature of the alleged criminal conduct in sufficient detail to enable the defendants to prepare their defenses and to plead an acquittal or conviction in bar of any future prosecution for the same offense." 616 F.2d at 28.[13] A fortiori, no more stringent standard of pleading is required in a civil action.

Of course, on remand, as in any Section 10(b) case, the Commission must prove scienter, and petitioner Underwood is on adequate notice from the complaint that he will have to defend on that issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
Solicitor General

EDWARD F. GREENE
General Counsel

JACOB H. STILLMAN
Associate General Counsel

ROSALIND C. COHEN
Assistant General Counsel

LOUIS C. WHITSETT
Attorney
Securities and Exchange Commission

NOVEMBER 1981

---

[13] See also *Weissbuch* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 833 (7th Cir. 1977); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 37 (2d Cir. 1976).

☆ U. S. GOVERNMENT PRINTING OFFICE: 1981 358073 688